

Internal Revenue Service  
**memorandum**

CC:TL-N-6785-90  
Br2:CTSanderson

date: JUN 7 1990

to: District Counsel, Philadelphia CC:PHI  
Attn: Steven R. Doroghazi

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This memorandum responds to yours of May 10, 1990, concerning the above-referenced CEP case.

ISSUE

Whether the taxpayer's deduction of the full amount of unstated interest computed under I.R.C. § 483(b), prior to the 1984 amendments, should be conceded in light of the Williams v. Commissioner, 94 T.C. No. 27 (March 21, 1990) and Weis v. Commissioner, 94 T.C. No. 28 (March 21, 1990) cases.

CONCLUSION

Although we disagree with the Tax Court's conclusion in Williams, we think it unlikely that the court would be reversed on appeal. Furthermore, because of the 1984 changes to section 483, a reversal of the Williams decision would have little precedential value. Therefore, the government will probably not appeal the Williams holding on this issue once decision in that case becomes final. Similarly, we do not think resources should be expended to litigate this issue in [REDACTED].

DISCUSSION

The facts of the [REDACTED] audit were used in Litigation Guideline Memorandum TL-[REDACTED] to describe the abuse of section 483 (prior to its amendment in 1984) that occurs when a promissory note with no stated interest is utilized by a purchaser solely for the purpose of achieving an accelerated interest deduction through a literal application of section 483.<sup>1</sup> The LGM took the position that interest allocated to any payment under such an abusive transaction is not allowable to the extent such deduction exceeds the amount of interest that economically accrued on the

<sup>1</sup> Because of the nature of your request, we have forgone a discussion of the facts. For a detailed discussion of the transaction involved in [REDACTED], see TL-[REDACTED].

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unpaid balance of the loan. The LGM reasoned that, although section 483 calculates the amount of total unstated interest and allocates the interest on a pro rata basis, all transactions subject to section 483 are also subject to the "clear reflection of income" standard set forth in section 446(b) and implied in section 461(a).

The Service litigated this position in Williams v. Commissioner, 94 T.C. No. 27 (March 21, 1990). Although the facts in Williams are somewhat different than those in [REDACTED], the abuse concerning "frontloading" of interest under section 483 is the same. The issue before the court in the parties' cross-motions for partial summary judgment in Williams was whether section 446(b) or section 461(g) limits petitioners' interest deduction to the amount of interest that economically accrued rather than to the amount of interest determined under section 483. The court rejected respondent's argument that for purposes of section 446(b), the pro rata allocation of interest created by section 483 should be treated as if it "were actually provided for in the contract," within the meaning of Treas. Reg. § 1.483-2(a)(1)(i). Williams, slip op. at 7.

The court gave three reasons for concluding that the quoted language of Treas. Reg. § 1.483-2(a)(1)(i) did not apply when respondent is attempting to override the pro rata allocation method of section 483. We think the first two reasons are unconvincing. However, an appellate court could easily find compelling the third reason, which was that such an interpretation of Treas. Reg. § 1.483-2(a)(1)(i) could effectively nullify old section 483 since it could cause the economic accrual method to apply in instances in which the pro rata allocation scheme of section 483 should be respected, i.e., nonabusive situations. See Williams, slip op. at 9. Compare Weis v. Commissioner, 94 T.C. No. 28 (March 21, 1990), in which the government required the taxpayer to follow the section 483 pro rata allocation formula rather than the economic accrual method. In Weis use of the pro rata allocation formula of section 483 did not result in a gross acceleration of interest.<sup>2</sup>

The court went on to reject respondents' argument that, even without Treas. Reg. § 1.483-2(a)(1)(i), section 446(b) allows the Service to override the pro rata allocation required by section

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<sup>2</sup> The timing of the Weis litigation relative to Williams was unfortunate. It required the government to defend the plain language of the Code and regulations in Weis while at the same time, combat the abusive scheme that arose in Williams. In any event, the position taken in the two cases was consistent because the section 483 regulations appeared to require use of the pro rata allocation formula in nonabusive situations while allowing application of interest deduction limitations in abusive cases.

483. Williams, slip op. 9. The court gave several reasons for this conclusion. We have some concerns about the court's language concerning the Commissioner's section 446(b) power with respect to statutorily prescribed accounting methods, a matter that could be addressed in an Action on Decision after decision is entered. However, we think it unlikely that an appellate court will conclude that the Tax Court was incorrect as a matter of law when it concluded that respondent may not use the general provisions of section 446(b) to override the specific provisions of section 483. Williams, slip op. at 10.

Respondent's 461(g) argument was also rejected. Williams, slip op. at 13. The court concluded that "section 461(g) will not place cash taxpayers on the economic accrual method if accrual taxpayers are not on that method." Id. Since accrual taxpayers are not on the economic accrual method under old section 483, but instead are subject to the pro rata allocation of interest, the court reasoned that section 461(g) did not place the cash method petitioners on the economic accrual method. Id.

The court concluded the opinion by noting that Congress prevented the abuse for years after 1984 by amending section 483 to require taxpayers to allocate their unstated interest according to the economic accrual method.

While we disagree with the court's conclusion that neither section 446(b) or section 461(g) can be used in these abusive situations, we think it unlikely that the court would be reversed on appeal. With the additional factor of the 1984 amendment, it does not appear to be economically feasible to expend further resources in litigating this issue in another case.


Further, an additional hazard exists in cases involving accrual method taxpayers, such as [REDACTED], that is not present in cases involving cash method taxpayers, such as Williams. The regulations underlying old section 483 do not vary from the ordinary rules found in section 461 as to the timing of unstated interest deductions for cash method taxpayers. However, such regulations provide a significant adjustment in the timing of unstated interest deductions for accrual method taxpayers. Compare the "All Events" Test of Treas. Reg. § 1.461-1(a)(2) with the provisions of Treas. Reg. § 1.483-2(a)(1) which permit a deduction for unstated interest by an accrual method taxpayer only when payment is due. Thus, an accrual method taxpayer presents a much more difficult case, from the government's perspective, than a cash method taxpayer because it is easier for an accrual method taxpayer to illustrate that old section 483 contains specific accounting rules for the treatment of unstated interest that cannot be overridden by the more general provisions of section 446(b) and, generally, section 461. Accordingly, we agree that this issue in [REDACTED] should be conceded.

Our advice concerning [REDACTED] should not be taken as determinative of our appeal recommendation on Williams. Although it is unlikely that the government would pursue the section 483 issue on appeal, a final decision on whether to appeal Williams has not been made, and cannot be made until the issues preserved for trial are resolved and decision becomes final. In this regard, it is possible that the taxpayer may appeal Weis. If so, a new light may be shed on our appeal consideration because the government could be viewed as being in a "whipsaw-like" position.

If you have any further questions, please contact Ted Sanderson on (FTS) 566-3289.

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